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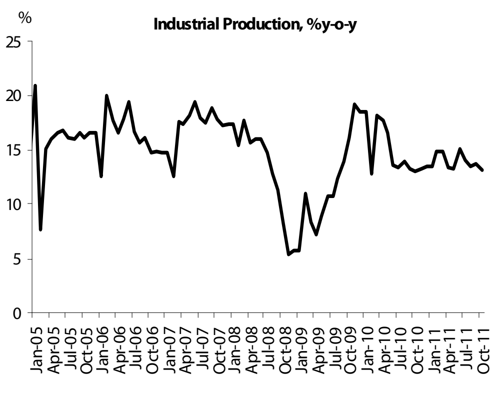
China: Recent data support our view of a soft-landing in the economy

- Recent activity indicators suggest the economy continued on a moderate growth pace, with solid growth in domestic demand compensating for weak exports.
- The government's ongoing policy reforms that aim at rebalancing the economy are expected to support steady improvement in private consumption.
- Import growth is expected to continue to outpace export growth, which is consistent with our view that domestic demand will remain the main driver of growth in the foreseeable future.
- Economic policy is expected to be particularly supportive for domestic demand growth. However, the central bank is not expected to cut policy rates soon, unless growth prospects deteriorate sharper than expected and headline inflation fall significantly.

October activity data: in line with a moderation in growth

China's October activity indicators suggest the economy continued on a moderate growth pace, supporting a soft-landing in growth. Overall, the data show a noticeable drop in inflation and continued solid growth in domestic demand which is compensating for weak exports. Industrial production moderated to a still solid rate of 13.2% y-o-y in October from an average of 13.8% y-o-y in Q3 2011 (Figure 1).

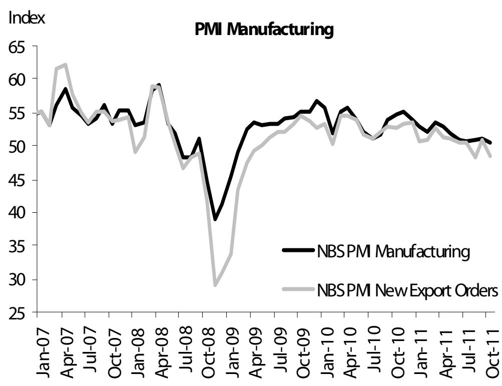
Figure 1



Source: Bloomberg

It seems that the slower IP growth was driven mainly by weaker exports, given that growth in both fixed assets investment (FAI) and retail sales was quite robust. Reinforcing the picture from the industrial sector, the October NBS PMI index fell to 50.4 in October from 51.2 in September, driven mainly by losses in new export orders (Figure 2). The new export orders PMI sub-index slipped again into contraction territory (48.6), after the bounce to expansion in September (50.9).

Figure 2



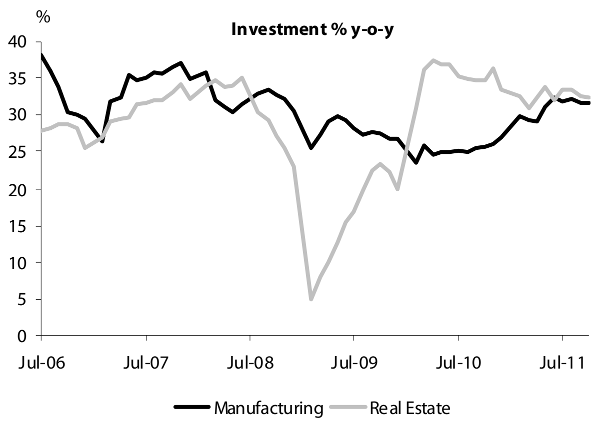
Source: Ecowin

It is worth noting that the y-o-y readings of industrial production in the second half of the year have been hovering in the range of 13-14%, implying that industrial production growth may have stabilized and, thus, downside risks could be limited. Indeed, selective easing measures, which are underway since mid-October, are expected to come into effect soon, helping the economy to regain momentum.

On the investment front, FAI growth came in stronger than expected at 24.9% y-o-y in October, compared with 24.3% in September. This reflects still strong manufacturing which offsets lower growth in infrastructure and real estate investment (Figure 3). The latter continues to be undermined by the ongoing tightening measures to slow property price increases. Forward-looking indicators on property investment, in particular floor space under construction, turned negative in October, falling 2.7% y-o-y, compared with an increase of 12% in September. This suggests that property investment will remain subdued in the coming months.

Looking at retail sales, growth in private consumption appears to remain healthy, albeit it has slowed slightly to 17.2% y-o-y in October from 17.7% in September. In fact, the average growth rate of retail sales so far in the second half of 2011 (17.3% y-o-y) is higher than the average rate of 16.7% in H1 2011. We expect the income tax cut for 60 million people, effective from September onwards, to underpin consumption looking ahead. Moreover, the government's ongoing policy reforms that aim at rebalancing the economy are expected to support steady improvement in private consumption.

Figure 3

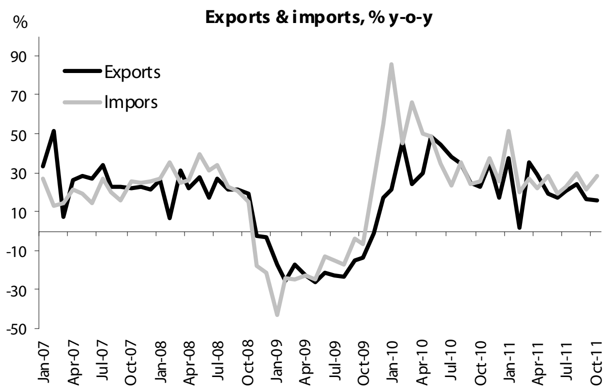


Source: Bloomberg

Exports on track of a mild slowdown, but imports remain firm

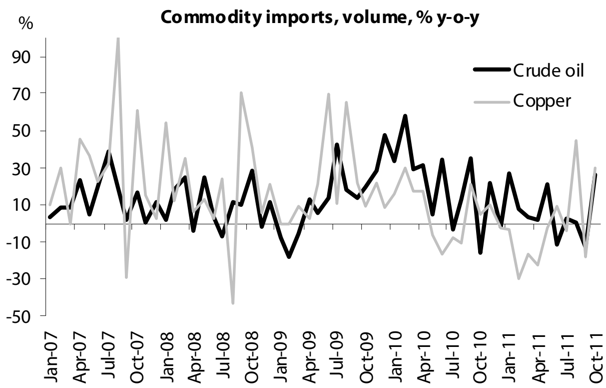
Meanwhile, export growth continued to face headwinds in October, since slow economic growth and high unemployment in China's major export destinations (i.e., US and Europe) are curbing consumption. October export growth decelerated to 15.9% y-o-y (the lowest growth rate in five months) from 17.1% in September and 24.5% in August. In contrast, import growth rebounded sharply to 28.7% y-o-y from 20.9% in September (Figure 4). This rebound probably implies robust demand, inventory building (e.g., import growth of crude oil and copper picked up in October, Figure 5) and some early effects from policy fine-tuning.

Figure 4



Source: Bloomberg

Figure 5



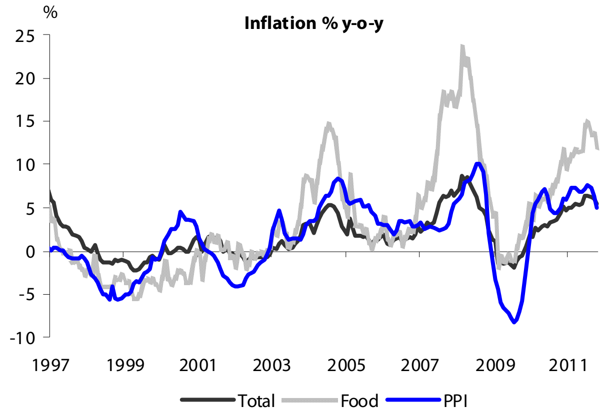
Source: Bloomberg

Although the Chinese economy faces some headwinds from weak external demand, the Canton Fair, a leading indicator of China's exports, points to a gradual slowdown of export growth instead of a slump. The Canton Fair is China's largest trade fair being held twice a year and a barometer of China's external trade. The 110[th] Canton Fair opened on October 14, 2011 and was wrapped up on November 4, 2011. The official statistics of the fair are encouraging despite lingering debt crisis in Europe. According to the data from the fair, export orders of this autumn session increased 8.8% y-o-y, a rate quite close to the average growth of 10% y-o-y in the past decade. The fair shows strong demand for export orders from emerging economies, while demand from the US and the Europe dropped by 24% and 19%, respectively, compared with the spring session. It is worth noting that many Chinese business executives at the fair indicated that they intend to turn their attention on domestic consumers, given far weaker demand from overseas markets. Looking ahead, we expect import growth to continue to outpace export growth, which is consistent with our view that domestic demand will remain the main driver of growth in the foreseeable future.

Macro policy: supportive for domestic demand growth

In the meantime, macro policy has turned to "selective supportive" in October when Chinese authorities have introduced new favorable terms concerning lending and tax policies to support small and medium sized enterprises (SMEs). For instance, the government called on commercial banks to provide more credit to SMEs, while it provided tax incentives to financial institutions that serve SMEs. With these targeted easing measures the government aims to facilitate restructuring of economic growth. Meanwhile, in the latest monetary policy report, published on November 16, the central bank indicated that it will continue to maintain the current prudent monetary policies, while making them more targeted and flexible. Taming inflation will continue to be the central bank's top priority. Indeed, the central bank made it clear that the nation's policies to control inflation could not be loosened, since the foundation of stable price levels is not solid yet. Although the October reading of CPI inflation shows that China's inflation eased gradually to 5.5% y-o-y from a three-year high of 6.5% y-o-y in July 2011 (Figure 6), there are still risks of a spill over of extremely loose global monetary conditions, still robust domestic economic expansion and rising labor costs into consumer prices. The results of a central bank survey conducted in 20,000 households in the third quarter shows that inflation expectations for the fourth quarter have risen, even though the year-on-year growth of consumer price index has been declining since August 2011. Overall, the People's Bank of China is not expected to cut policy rates soon, unless growth prospects deteriorate sharper than expected. We project real GDP growth to moderate to 9.3% y-o-y in 2011 and 8.9% y-o-y in 2012. This moderation can be considered a soft landing, with the risk of a marked slowdown rather low.

Figure 6



Source: Bloomberg

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